

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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In the Matter of)	
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Access Charge Reform)	CC Docket No. 96-262
)	
Price Cap Performance Review for Local Exchange Carriers)	CC Docket No. 94-1
)	
MCI Telecommunications Corp. Emergency Petition for Prescription)	CC Docket No. 97-250
)	
Consumer Federation of America Petition for Rulemaking)	RM-9210
)	

COMMENTS OF THE AD HOC
TELECOMMUNICATIONS USERS COMMITTEE

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SUMMARY

The Ad Hoc Telecommunications Users Committee supports reform of the interstate access charge rules and a substantial downward adjustment in interstate access rate levels. Most participants in the telecommunications industry agree that interstate access charges are too high. Competition in the local exchange and exchange access service markets is not widespread and has not grown quickly. Given the failure of competition to take root sufficiently to support a market-based approach to setting interstate access service rates, the Committee urges the Commission to exercise its authority to drive interstate access charges to levels closer to the forward looking costs.

To that end, the Commission's first, but not final, step should be to increase the X-Factor that is used to set interstate access service rates. The X-Factor used to set interstate rates should be based on interstate operations, not total company results. Making this correction would move the X-Factor to nine or ten percent. Ad Hoc takes this opportunity to present significant additional factual evidence from state price cap proceedings around the country that demonstrate that there indeed exists a systematic difference between ILEC interstate and intrastate productivity factors, and that the ILECs themselves have acknowledged this difference. The Commission can use its own data to calculate an interstate X-Factor. The calculation is straight forward.

The Committee also supports granting ILECs some pricing flexibility, provided it is linked to clear evidence of competitive conditions in relevant

markets and that appropriate safeguards exist to ensure that ILECs do not compete unfairly or impose cross-subsidy burdens on customers who do not have realistic competitive alternatives to the ILECs' services. Pricing flexibility serves the public interest generally because it holds the potential to send more accurate pricing signals to the market. Moreover, consumers will benefit from expanded choices. The Committee supports the availability of RFP pricing flexibility to allow ILECs to respond to RFPs with contract prices in competitive situations.

The Committee has, however, significant concerns about the pricing flexibility proposals currently under consideration. In particular, the Committee does not support basing the availability of pricing flexibility on potential competition rather than effective competition, and has significant concerns about the impact on consumers in non-competitive markets. Because the proposals on the record are summary in nature and rely upon the use of conclusory arguments, unsupported factual data and shorthand references lacking explanation, Ad Hoc's discussion is necessarily preliminary in nature. The Committee anticipates responding in detail to the various proposals once a fuller explication is presented on the record.

Finally, as an alternative to a fully prescriptive backstop approach, the Committee recommends that the Commission consider the Committee's "Make Whole or Make Money" framework, which would allow ILECs to choose between a "make whole" option of guaranteed recovery of their embedded accounting costs, including the excess above economic cost levels, but under Commission

oversight of their earnings and pricing, and a “make money” option in which the ILEC would accept a prescription of access rates at economic (TSLRIC) levels, but with pricing flexibility and no regulatory restraints on earnings. The Commission should not allow ILECs to have it both ways; they should not have the earning and pricing flexibility that competitive firms need while at the same time enjoying guaranteed recovery of their investments. Allowing the ILECs to have it both ways would be fundamentally anti-competitive.

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**COMMENTS OF THE AD HOC
TELECOMMUNICATIONS USERS COMMITTEE**

The Ad Hoc Telecommunications Users Committee (hereinafter "Ad Hoc" or "the Committee") hereby responds to the Commission's October 5, 1998 Public Notice inviting parties to refresh the record in the above-referenced proceedings and seeking comment on proposals for access charge reform pricing flexibility. Consistent with the views it has expressed throughout these proceedings,¹ the Committee supports a fundamental reform of the interstate

¹ *In the Matter of CC Docket No. 96-262, Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, Transport Rate Structure and Pricing, CC Docket No. 91-213, and Usage of the Public Switched Network by Information Service Providers and Internet Access Providers, CC Docket No. 96-263, Comments of the Ad Hoc*

access charge rules and a substantial downward adjustment in rate levels. The Committee also supports granting incumbent local exchange carriers (ILECs) some pricing flexibility, but only in instances in which they face actual competition, provided they are not allowed to compete unfairly or to impose cross-subsidy burdens on customers who do not have realistic competitive alternatives to the ILECs' services.

Ad Hoc supports efforts to increase the level of sustainable and effective competition in telecommunications markets. Effectively competitive telecommunications markets are the best means for providing consumers with reasonably priced, state-of-the-art telecommunications services. Certainly that is the case for members of the Ad Hoc Committee. These entities are large, sophisticated buyers of telecommunications services. They benefit from real competition. They have no reason to needlessly restrict ILEC competitive moves, and have no reason to protect competitive local exchange carriers (CLECs) from legitimate competition. Restraining real competition does not help Ad Hoc Committee members or the public generally. Ad Hoc gives the Commission a clearer, less distorted view of telecommunications markets than do competing suppliers who seek to use the regulatory process for their legitimate but narrow self-interest.

Telecommunications Users Committee (Jan. 29, 1997) ("Ad Hoc Comments"); *In the Matter of CC Docket No. 96-262, Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, Transport Rate Structure and Pricing, CC Docket No. 91-213, and Usage of the Public Switched Network by Information Service Providers and Internet Access Providers, CC Docket No. 96-263, Reply Comments of the Ad Hoc Telecommunications Users Committee* (Feb. 14, 1997). ("Ad Hoc Reply Comments").

A. Access Charge Reform

The goal of rate regulation should be to produce, in the absence of effective competition, a marketplace for carriers and their customers that emulates competitive markets as closely as possible. Most participants in the telecommunications industry agree that interstate access charges exceed just and reasonable levels by a significant degree. That would not be the case if the local exchange and access service market were effectively competitive. To drive interstate access charges to levels closer to those that would pertain if the market were effectively competitive, the Commission must exercise its rulemaking authority to move to a forward-looking economic cost basis for interstate access rates, raise the X-factor and lower the ILECs' authorized earnings.

1. Current State of Local Exchange and Exchange Access Competition

The Common Carrier Bureau's Local Competition Survey provides strong evidence, confirming the experience of the Ad Hoc members, that competitive inroads in the local exchange and exchange access service markets have been small and hardly ubiquitous in nature.² As shown in Appendix 1 to these Comments, within the major ILECs' serving areas, in the aggregate, only about 1% of the local service lines were being resold on a "bundled" (*total service resale* or *TSR*) basis, less than *one tenth* of one percent of local service lines

² Responses to the FCC's First Survey on the State of Local Competition (March 27, 1998) are available for download from www.fcc.gov/ccb/local_competition/survey/responses.

were being provided over UNE loops purchased by CLECs, and about 0.14% of local numbers had been "ported" by ILECs to competing local service providers via interim local number portability.³ Out of a total of some 11,500 serving wire centers identified by the major ILECs, only 420 (4%) had a physical collocation arrangement with at least one CLEC utilizing UNE loops. These data confirm the local exchange and access service market is still dominated by the ILECs. The niche competition that does exist is insufficient to police the ILECs' pricing and practices.

The level of local exchange and exchange access service competition has not materially increased since release of the Local Competition Survey. In the Commission's SBC/Ameritech merger proceeding⁴, SBC submitted data, as of June 30, 1998, which it claimed showed significant competitive inroads in its home region. The SBC submission identified a total of 1,017,883 "CLEC lines" across the seven-state SBC operating territory.⁵ Included within this count,

³ See Appendix 2: Summary of FCC Local Competition Data, by ILECs. Local numbers must be "ported" when an ILEC's existing local service customers take service from a CLEC that is providing its own switching and desire to keep their local phone number. The total quantity of such numbers provides a reasonable proxy for the total number of CLEC lines provided over CLEC, as opposed to ILEC, facilities. While the number does not include CLEC-provided local service lines where the customer did not desire to keep the same phone number (e.g., new service installations, out-going only trunks, computer and fax lines), it does include some percentage of lines that are also included in the UNE loop counts (situations where the CLEC combines an ILEC UNE loop with its own switching).

⁴ See SBC Communications, Inc. and Ameritech Corporation Seek FCC Consent for a Proposed Transfer of Control and Commission Statement on Proposed Protective Order Filed by SBC and Ameritech, *Public Notice*, DA 98-1492 (CCB rel. July 30, 1998).

⁵ Application of Ameritech Corporation and SBC Corporation Inc. for Authority, Pursuant to Part 24 of the Commission's Rules, to Transfer Control of a License Controlled by Ameritech Corporation, (July 24, 1998) ("SBC/Ameritech Merger Filing"): Applicant's Description of the Transaction, Public Interest Showing and Related Demonstrations, Affidavit of Stephen M. Carter (President of SBC's Special Markets Group), Attachment 1, at 1.

however, were 649,962 "CLEC lines" that were identified as "resold" SBC services. Thus, only 367,921 lines, or slightly over 1%, of the 32-million-plus access lines in the SBC region, were identified by the ILECs as *facilities-based* CLEC services.⁶ Even if all 1,017,883 "CLEC lines" are considered, the CLECs would hold only about 3% of SBC's access lines.

Ameritech also provided a limited set of updated numbers in an affidavit submitted in CC Docket 98-141, pertaining to the number of lines resold and the provisioning of number portability (both interim and permanent). While these data show some increase in local exchange and exchange access competition compared to the competitive entry shown in Local Competition Survey (e.g., 4% of Ameritech's lines were being resold, compared to the earlier 2.3%, and 0.5% of lines being ported, compared to the year-end 1997 figure of 0.4%),⁷ this minimal level of competition is insufficient to constrain prices for ILEC-provided services.

⁶ *Id.* SBC's derivation of 367,921 count is somewhat unclear. The supporting charts at pages 6-7 of Attachment 1 to Mr. Carter's affidavit identify 367,921 "facilities based CLEC end user E-911 listings." Separately, Mr. Carter shows 60,535 unbundled loops for the entire SBC region. These 60,535 UNE loops are presumably a subset of the 367,921 lines that SBC has identified as being "facilities-based." Like customers served via resale, customers served over UNE loops also continue to generate revenue for SBC. Thus, SBC has not completely lost this business.

⁷ SBC/Ameritech Merger Filing, Affidavit of Terry D. Appenzeller (Ameritech Vice President - Open Market Strategy and Director - Local Competition)., This affidavit provides only "raw" numbers for lines provided on a resale basis and ported numbers, not percentages. The percentages which appear above compare these raw numbers (810,000 resold lines and 110,700 lines served by interim and long-term number portability) to the approximately 20.5-million lines Ameritech serves, as reported in the Local Competition Survey. See SBC/Ameritech Merger Filing, Appenzeller Affidavit at ¶¶ 15, 20.

Other signs exist that demonstrate local competition is not growing as rapidly as the ILECs contend. The Eight Circuit ruling that ILECs need not recombine UNEs⁸ has created a severe technical impediment to CLECs' ability to use UNEs on an efficient and cost-effective basis. The few ILECs who have agreed to perform recombination functions have delayed implementation of tariffs to provide the service.⁹ Even in states where significant numbers of interconnection agreements have been signed and where there is nominal offering of unbundled loops and switching capability, there appear to be serious problems with nondiscriminatory access to ILEC operations support systems (OSS).¹⁰ For example, in July of this year, the New Jersey Board of Public Utilities (BPU) concluded that nondiscriminatory access to OSS and access to UNE combinations were the primary barriers to development of local competition

⁸ *Iowa Utilities Bd. et al. v. FCC*, 120 F.3d 753 (8th Cir. Oct. 14, 1997).

⁹ See, *Connecticut DPUC Investigation Into Rebundling of Telephone Company Network Elements*, Docket No. 98-02-01, *Decision*, August 17, 1998 (granting Connecticut ILECs a six month extension to file tariffs for recombined UNEs in response to CLEC requests.).

¹⁰ The inadequacy of OSS continues to be a major stumbling block in ILECs' attempts to satisfy the requirements of Section 271. See *Application of BellSouth Corporation, et al., Pursuant to Section 271 of Communications Act of 1934, as amended, to Provide In-region, InterLATA Services in Louisiana*, CC Docket No. 97-231, Memorandum Opinion and Order, FCC 97-228, (rel. Feb. 4, 1998) at ¶¶ 1, 20-58; *Application of BellSouth Corporation, et al., Pursuant to Section 271 of Communications Act of 1934, as amended, to Provide In-region, InterLATA Services in South Carolina*, CC Docket No. 97-208, Memorandum Opinion and Order, FCC 97-418, (rel. Dec. 24, 1997) at ¶¶ 101-81; *Application of Ameritech Michigan Pursuant to Section 271 of the Communications Act of 1934, as amended, to Provide In-region, InterLATA Services in Michigan*, CC Docket No. 97-137, Memorandum Opinion and Order, FCC 97-298 (rel. Aug. 19, 1997) at ¶¶ 128-221. The Commission did not reach the issue of OSS compliance with regard to SBC's Section 271 filing for Oklahoma because other serious threshold deficiencies in the application made it unnecessary for the Commission to reach questions regarding the specific elements of checklist compliance. See *Application of SBC Communications Inc. Pursuant to Section 271 of the Communications Act of 1934, as amended, to Provide In-region, InterLATA Services In Oklahoma*, CC Docket No. 97-121, Memorandum Opinion and Order, FCC 97-228, (rel. June 26, 1997) at ¶ 66.

in that state.¹¹ In particular, after hearing testimony from CLECs that ILEC-to-CLEC customer transfers were taking four to eight weeks, the Board concluded that the ILEC's OSS was not capable of migrating large numbers of customers to CLECs.¹² While the Board adopted an "action plan" to attempt to open the state's local markets to competition, the fact that the Board found it necessary to do so now, nearly three years after passage of the Telecommunications Act, only underscores how little progress local competition has been able to make in New Jersey.

The recent merger announcement between AT&T and TCI may suggest that AT&T has concluded that it cannot compete successfully in the local exchange and exchange access service market by relying on ILEC unbundled loops and resale to supply competitive local service.¹³ Moreover, AT&T apparently does not expect to begin providing telephony services over TCI's cable infrastructure until sometime in 2000, following upgrades that are expected to cost some \$1.8-billion (with an estimated cost per household of \$300 to \$500).¹⁴ The prospects for emergence of effective competition in the local exchange and exchange access service market in the next few years appear not good.

¹¹ "New Jersey Regulators Adopt Local Competition 'Action Plan,'" *Telecommunications Reports*, July 27, 1998, at 32.

¹² *Id.*

¹³ "Armstrong Says Bell Choke Hold Drove AT&T-TCI Merger Agreement, Denies Reports of Deal Changes," *Telecommunications Reports*, July 6, 1998.

¹⁴ *Id.*

Further evidence that competition in the local exchange and access service markets is not growing quickly lies in the fact that in the nearly three years since passage of the Telecommunications Act, not a single BOC has been able to demonstrate compliance with the requirements of Section 271 of the Act. But even if had an ILEC satisfied the competitive checklist, that would not be sufficient to demonstrate that effective competition exists. As the Commission recognized in its Order on the NYNEX/Bell Atlantic merger:

Even upon hypothetical full implementation of the Telecommunications Act of 1996, significant barriers to entry into the local telecommunications marketplace will remain. Entrants must still be able to attract capital, as well as to amass and retain the technical, operational, financial and marketing skills necessary to operate as a telecommunications provider in the local market. For mass market services, entrants will have to invest in establishing the brand name recognition and, even more importantly, the mass market reputation for providing high quality telecommunications services. These consumer "goodwill" assets take significant amounts of time and resources to acquire. An unknown entrant's attempts to build "goodwill" by providing reliable, high quality service relies heavily on the cooperation of the incumbent LECs that provides interconnection, unbundled elements, resold services or transport and termination, and can be frustrated by the incumbent LECs if that carrier engages in discriminatory conduct affecting service quality, reliability or timeliness. For all these reasons, we cannot at this time simply assume that implementation of the Telecommunications Act of 1996 and the potential for development of competition will eliminate any concerns about potential competitive effects of mergers, particularly the effects on the pace of the development of competition.¹⁵

¹⁵ *In the Matter of NYNEX Corporation Transferor, and Bell Atlantic Corporation Transferee*, Memorandum Opinion and Order, File No. NSD-L-96-10, (rel. Aug. 14, 1997) at ¶ 42. ("Bell Atlantic/NYNEX Merger Order").

The Commission's clear understanding of the challenges facing new entrants stands in stark contrast to ILEC assertions that competition has in fact arrived.

ILEC interstate earning and traffic growth provide further evidence that competition is not strong enough to constrain ILEC pricing for interstate access service. With few exceptions,¹⁶ the major ILECs' interstate earnings levels remain excessively high. In 1997, Bell Atlantic and U S West reported interstate returns of 15%, those of Ameritech and BellSouth were at 18%, and GTE and Sprint's interstate returns reached the 20% level on an aggregate basis, and have been increasing since 1991, the first year for price caps.¹⁷ In numerous study areas, GTE and Sprint report 1997 interstate rate of return exceeding 30%,¹⁸ and even in excess of 40%.¹⁹ Clearly, market forces are offering no protection to access customers in those areas from gross overcharges by the dominant ILEC.

In addition, the ILECs continue to enjoy strong demand growth for their interstate switched access services, as evident from the statistics and accompanying graph of year-by-year changes that has been prepared by the Industry Analysis Division (reproduced as Figure 1 in the Appendix 2 to these

¹⁶ The SBC companies Southwestern Bell and Pacific Bell reported decreased interstate earnings in 1997, presumably as a result of costs incurred in implementing the SBC/Pacific Telesis merger. *Trends in Telephone Service*, (IAD rel. July 1998) at Table 14.1 (Interstate Rate of Return Summary).

¹⁷ *Id.*

¹⁸ *Id.* (GTE-California (Nevada Contel)/Contel of California, 31%; GTE-South (Virginia only –COVA), 34%; GTE-North (COPA and COQS), 37%; Sprint (United Telephone of the Northwest), 31%.)

¹⁹ *Id.* (GTE-North (Illinois Contel), 41%; GTE-Southwest (Contel New Mexico) *et al*, 49%, Sprint (Central Telephone of Texas), 43%).

Comments). As shown therein, ILECs switched nearly 500 billion interstate access minutes in 1997, which represents a 6.4% increase from the 1996 level. While output is obviously affected by other factors, such as general economic conditions influencing demand for toll and the Commission's restructuring of access rate elements, there is no evidence that ILECs are suffering reduced use of their switched access services due to competitive alternatives.

In retrospect, the slow emergence of local competition is not particularly surprising. The Commission should recall the slow growth of competition in the interstate toll market. It took about twenty years from the original *Specialized Common Carrier* ruling in 1971 that permitted MCI to construct competitive intercity facilities²⁰ until the Commission concluded that the interexchange long distance services market had become competitive enough to relax its regulation of AT&T's prices.²¹ The Commission's hope that local competition could develop sufficiently in a few years to constrain access prices has simply been too optimistic.

2. Implement a Prescriptive Approach

Given the manifest failure of local competition to take root sufficiently to support a market-based approach in the interstate access arena, the immediate question is what is the next best recourse. The Commission has already

²⁰ *In the Matter of Establishment of Policies and Procedures for Consideration of Application to Provide Specialized Common Carrier Services in the Domestic Public Point-to-Point Microwave Radio Service and Proposed Amendments to Parts, 21, 43, and 61 of the Commission's Rules*, Docket No. 18920, 29 FCC 2d. 870 (rel. June 3, 1971) at ¶ 907.

²¹ *In the Matter of Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier*, Order, 11 FCC Rcd 3271 (1995) ("AT&T Non-Dominant Order").

recognized the need for an alternative tool in the event that reliance on market forces proved ineffective:

In addition, we also adopt a prescriptive "backstop" to our market-based approach that will serve to ensure that all interstate access customers receive the benefits of more efficient prices, even in those places and for those services where competition does not develop quickly. To implement our backstop to market-based access charge reform, we require each incumbent price cap LEC to file a cost study no later than February 8, 2001, demonstrating the cost of providing those interstate access services that remain subject to price cap regulation because they do not face substantial competition. *The Commission will require submission of such studies before that date if competition is not developing sufficiently for our market-based approach to work.*²²

It is clearly time for the Commission to move to a "backstop" prescriptive approach. A prescriptive approach that seeks to align interstate access service rates with relevant costs should start with increasing the X-Factor in the Commission's price caps rules. This change will not be sufficient in itself to move interstate access service rates to forward looking economic cost levels because the price caps model initially set interstate access rates based on embedded costs. Subsequent adjustments to the price caps formula have increased the X-Factor but have not driven interstate access service rates to forward looking economic cost levels. The further increase in the X-Factor will, however, move interstate access service rates in the right direction and thus, is

²² Access Charge Reform, CC Docket No. 96-262 et al., First Report and Order, 12 FCC Rcd 15982 (1997) ("Access Charge Reform Order"), at para. 267 (emphasis supplied); *aff'd sub nom. Southwestern Bell Tel. Co. v. FCC*, __ F.3d __ (8th Cir., Aug. 19, 1998); Order on Reconsideration, 12 FCC Rcd 10119 (1997), Second Order on Reconsideration and memorandum Opinion and Order, 12 FCC Rcd 16606 (1997).

an appropriate transition measure until relevant forward-looking cost studies are submitted and reviewed.

3. Increase the X-Factor

In the Commission's Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262, the Commission adopted an X-Factor far below its appropriate level for interstate services.²³ The Commission's X-Factor analysis erred significantly by computing the X-Factor for price cap LECs based on total company operations. The X-Factor is far too low primarily because the Commission failed to calculate the X-Factor based solely on LEC interstate revenues. This error constitutes a significant flaw in the Commission's own X-Factor calculations, the correction of which alone leads to the Commission's model producing X-Factor estimates of over nine percent.

a. Calculate the X-Factor on an Interstate-only Basis

Compelling reasons support calculating the X-Factor applicable to the LECs' interstate services on an interstate-only basis. The rate of growth for interstate switched access minutes has historically exceeded that of intrastate services and continues to do so. For example, a 1998 Commission report shows that during the post-divestiture period the predominant intrastate service —

²³ See Petition for Reconsideration on Behalf of Ad Hoc Telecommunications Users Committee and attached Declaration of Patricia D. Kravtin, *Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1, and *Access Charge Reform*, CC Docket No. 96-262, July 11, 1997. Although Ad Hoc urged the Commission to reconsider several aspects of the access Charge Reform Order, it subsequently moved for dismissal of its petition. These comments, submitted in response to the Commission's October 5, 1998 Public Notice, should not

individual subscriber access lines — has grown by approximately 4 percent per year nationally, as has total Dial Equipment Minutes (DEMs).²⁴ By contrast, *interstate* switched access minutes — the predominant interstate service — has experienced annual growth rates in the vicinity of 9 percent.²⁵ Even the price cap LECs themselves have readily acknowledged that the higher demand growth for interstate services will have a direct and positive impact on interstate output, and hence interstate productivity.²⁶

Furthermore, the processes by which individual LEC services are produced vary considerably, particularly with respect to the relative cost shares of labor and capital and the pace of technological change for the inputs and processes with which each such service is created. Intrastate subscriber access lines, for example, involve a highly stable technology (copper loops) and exhibit a relatively high labor component for installation, maintenance and customer service (retailing) functions. By contrast, switched services, like the LEC's interstate switched access services, have been and continue to be heavily impacted by technology (digital switching, Signaling System 7, Advanced Intelligent Network) and to require minimal labor input on an ongoing basis.

be construed as an implicit request for consideration or reinstatement of the above-mentioned petition for reconsideration.

²⁴ *Trends in Telephone Service*, (IAD rel. July 1998). Total DEMS include local, intrastate toll and interstate toll.

²⁵ *Id.*

²⁶ See CC Docket 94-1, NYNEX Comments at 13, Ameritech Comments at 7.

Given this technology profile, it is evident that the particular mix of services regulated at the interstate level will experience significantly *lower* overall cost growth on a per-unit basis, and thus *higher* productivity gains, than the mix of services regulated at the intrastate level, particularly given the faster rate of growth for interstate outputs relative to intrastate outputs.

Another very compelling reason why the Commission should rely on an interstate-only X-Factor is that failure to do so creates a windfall opportunity for LECs. The use of a total company X-Factor measure as the basis for an interstate X-Factor will create a systematic upward bias in year-to-year changes in interstate rate levels, which will permit the LEC to amass and retain persistent, excessive interstate earnings. As Ad Hoc argued previously, even if the use of a total company productivity factor results in combined state and interstate earnings that seem reasonable, the separate jurisdictional treatment means that LECs will be able to game the system by keeping the interstate windfall while at the same time claiming under-recovery and under-earnings in the state jurisdiction and potentially evoking low-end protection mechanisms — or even the fifth amendment protection against confiscation — based upon low intrastate earnings.²⁷

The Commission did not substantively address this argument in the Access Charge Reform Order, finding only that “unsupported claims of a potential LEC windfall do not by themselves convince us that there is any factual

²⁷ *Establishing the X-Factor* pp. 48-49.

basis for concluding there is a systematic difference between interstate and intrastate productivity."²⁸ Ad Hoc takes this opportunity to present significant additional factual evidence from state price cap proceedings around the country that demonstrate that there indeed exists a systematic difference between LEC interstate and intrastate productivity levels. This new evidence is in the form of rulings and other record evidence from state proceedings around the country that demonstrate across diverse regions and companies that LECs have argued such differences exist, and that state commissions have adopted productivity factors and systems of price cap regulation that explicitly takes these differences into account.

District of Columbia (Bell Atlantic- Washington, D.C)

In the District of Columbia's Public Service Commission's proceeding considering price regulation, a Bell Atlantic witness argued strongly in favor of a productivity measure based on intrastate-only conditions:

The Staff recommendation for a total company productivity study (including FCC regulated interstate operations) would be contrary to the use of intrastate productivity studies starting with Formal Case No. 798 (Order No. 7866, dated October 3, 1983). The Staff has not raised any arguments to reverse the history of intrastate only productivity studies being germane to intrastate ratemaking, and their proposal would add considerable record keeping to track non-intrastate price increases.²⁹

²⁸ Ad Hoc Petition for Reconsideration at 13 (*citing* Access Charge Reform Order, para. 111).

²⁹ Rebuttal Testimony of Richard G. Petzold (Bell Atlantic-DC), District of Columbia Public Service Commission, Formal Case No. 814, Phase IV, September 15, 1995, at 18.

North Carolina (BellSouth).

Similarly, in a price cap proceeding in North Carolina, a BellSouth witness stated his belief that with regard to interstate productivity:

"[i]t is reasonable to expect that productivity growth experienced historically in this market [for interstate access services] would be substantially greater than the overall rate of productivity growth experienced by local exchange companies in supplying all services."³⁰

The witness, Dr. William Taylor, further drove home the point that:

... even if the productivity differential is 5.3 percent per year for interstate access services, this would not imply that a similar productivity differential was appropriate for other components of telephone service. To the contrary, the productivity differential for services in the state jurisdiction must necessarily be less than 5.3 percent per year.³¹

Ad Hoc strongly agrees with Dr. Taylor's conclusion that "interstate productivity growth must be faster than the overall average productivity growth for local carriers."³² Of course, the logical application of Dr. Taylor's reasoning to the interstate jurisdiction is that the true productivity factor in the interstate jurisdiction must necessarily be more than the Commission's calculated total company LEC productivity of 6.0%.

³⁰ Amended Direct and Rebuttal Testimony of Dr. William E. Taylor (Carolina Telephone and Telegraph Co. and Central Telephone Co.), North Carolina Utilities Commission, Docket No. P-7, Sub 825; P-10, Sub 479, February 9, 1996, at 38.

³¹ *Id.*, at 38-39.

³² *Id.*, at 39.

Maine (NYNEX). The Maine Public Utilities Commission selected a 4.5% X Factor instead of the Commission's then-highest productivity factor of 5.3%, explaining that:

We will not go as far as the FCC because...the price cap in Maine applies to different services than the interstate price cap, and interstate output quantities may be higher than those for intrastate.³³

Thus, the finding of the Maine commission of a differential intrastate productivity was based upon the exact type of demand growth evidence Ad Hoc has presented in these comments and previously in support of an interstate-only productivity measure.

Vermont (NYNEX): In establishing alternative regulation for NYNEX, the Vermont Public Service Board set a productivity factor of 4.0% to reflect explicitly "the opportunities that NET now has to gain efficiencies in the use of Vermont's modernized network"³⁴ given the fact that it "deployed digital switches to serve 87 percent of the network access lines, has deployed interoffice fiber, and, since 1989, has invested more than \$280 million in the Vermont telecommunications network."³⁵ The Board rejected a proposed productivity offset which was based upon studies that "examine significantly broader industries than the local

³³ Re: New England Telephone and Telegraph Co. d/b/a/ NYNEX, Maine PUC Docket No. 94-123 (rel. May 15, 1995), 162 PUR4th (1995) 38, at 73.

³⁴ Re: New England Telephone and Telegraph Company, VT PSB Docket Nos. 5700/5702 (rel. Oct. 5, 1994), 157 PUR4th (1995) 112, at 167.

³⁵ *Id.* at 171.

exchange carrier industry,” and, moreover, *did not reflect the conditions pertaining to the local exchange in Vermont.*³⁶

New York (NYNEX). Rather than adopt a single, fixed productivity factor, the New York Public Service Commission established as the main part of its plan a series of specific, annual rate reductions NYNEX would apply to specific categories of services.³⁷ By this methodology, a productivity factor becomes merely “a fallout figure that is used to evaluate the reasonableness of the projected outcomes of those pricing provisions.”³⁸ Given the nature of the New York plan, this implied productivity factor (approximately 4.33%, assuming an inflation rate of 3.1%³⁹) is by definition a purely intrastate figure.

New Jersey (Bell Atlantic-New Jersey): In New Jersey, the Board of Regulatory Commissioners ordered that, while parties had suggested productivity offsets as high as 4.5%, “a static offset of a lower value in recognition of NJ Bell's acceleration of technology is appropriate. Therefore, the Board modifies the plan

³⁶ *Id.* (emphasis added).

³⁷ Proceeding on Motion of the Commission to Investigate Performance-Based Incentive Regulatory Plans for New York Telephone Company - Track 2, *Opinion and Order Concerning Performance Regulatory Plan*, NY PSC Case No. 92-C-0665, Opinion No. 95-13 (rel. August 16, 1995), at 8-9.

³⁸ *Id.* at 60.

³⁹ *Id.*

to include a 2% offset for productivity gains.⁴⁰ In this instance, the New Jersey commission granted regulatory leniency to the LEC in exchange for infrastructure investment commitments. This is clear demonstration of the importance state regulators place on uniquely intrastate conditions in determining an appropriate LEC productivity factor.

The New Jersey Plan also includes an earnings sharing component which, whether part of an indexed price cap or a more general rate freeze, represents another way in which state commissions apply intrastate-only results. In establishing New Jersey Bell's alternative regulation plan, the New Jersey commission found that "if NJ Bell's intrastate return on equity for its rate regulated services exceeds 13.9%, those excess earnings would be shared equally between NJ Bell and its customers."⁴¹

Pennsylvania (Bell Atlantic-Pennsylvania): Similarly, in Pennsylvania, where the Recommended Decision on the establishment of a price cap called for a 5.29% X-factor,⁴² the Public Utility Commission instead approved a much lower 2.93% X-factor, reflecting at least in part the expected benefits to be gained by

⁴⁰ Re: New Jersey Bell Telephone Company, *Order*, NJ Board of Regulatory Commissioners Docket No. TO92030358 (rel. May 6, 1993), 143 PUR4th (1993) 297, at 333.

⁴¹ *Id.* at 6.

⁴² Re: Bell Atlantic - Pennsylvania, Inc's Petition and Plan for Alternative Form of Regulation Under Chapter 30, *Recommended Decision*, PA PUC Docket No. P-00930715 (rel. April 21, 1994), at 174-179.

ratepayers from Bell Atlantic-Pennsylvania's promise to deploy a statewide broadband-capable network.⁴³

California (Pacific Bell and GTE-California): The California Public Utilities

Commission cited an apparent sudden decline in the *intrastate* rates of return for Pacific Bell and GTEC in the first six to eight months of 1995 as one of several reasons for its decision to suspend its price cap index formula and replace it with a rate freeze.⁴⁴ California is a prime example of the opportunities available to the LECs to game the interstate-intrastate jurisdictional system. Although the state commission in California originally adopted a productivity factor based on total company data, it ultimately modified its system of price cap regulation (to one demonstrably more favorable to the LECs) based upon LEC arguments pertaining to *intrastate-specific* conditions.

b. Increase the X-Factor to Nine or Ten Percent

LECs have contended that an *interstate-only* productivity is not appropriate because it is not possible to calculate an economically meaningful interstate-only X-Factor. This argument, however, is belied by the existing system of jurisdictional separations, which provides a fully sufficient and quantifiable basis for performing an interstate-only X-Factor measure. Indeed,

⁴³ Re Bell Atlantic - Pennsylvania, Inc.'s Petition and Plan for Alternative Form of Regulation Under Chapter 30, *Decision*, PA PUC Docket No. P-00930715 (rel. June 28, 1994), 82 PA PUC 194, at 231-233; 252-258.

the Commission's own formulas and data, as presented in the charts in Appendix D of the Access Charge Reform Order,⁴⁵ are perfectly sufficient to calculate separate productivity factors for the LECs' interstate services only. In the charts presented in Appendix D, the Commission provides all data series related to LEC output growth disaggregated into individual LEC service categories. Thus, it is very straightforward to calculate an interstate-only output growth rate by simply omitting from the calculations those data series pertaining to the LECs' intrastate service offerings and replicating the Commission's analysis.⁴⁶ This straightforward process yields an interstate-specific output growth series.

With regard to the calculation of an interstate-specific input growth series, because most LEC plant and associated expenses are assigned to the interstate jurisdiction on the basis of a fixed 25/75 ratio, the growth of aggregate jurisdictional costs over time is largely unrelated to the disparate growth in jurisdictional revenues.⁴⁷ It follows, therefore, that input growth in the interstate jurisdiction can be reasonably approximated by total company input growth.

⁴⁴ Incentive-Based Regulatory Framework for Local Exchange Carriers, California PUC I.95-05-047, D.95-12-052 (rel. Dec. 20, 1995), 167 PUR4th (1996) 1, at 16.

⁴⁵ *Access Charge Reform Order*, at Appendix D, "Estimation of TFP under FCC Rules, FCC Synthesis."

⁴⁶ The data series pertaining to intrastate services which are appropriately removed from the calculation of interstate output growth are local service and intrastate toll and intrastate access.

⁴⁷ Ad Hoc Reply Comments, Attachment A: L. Selwyn and P. Kratvin, "*Establishing the X-Factor for the FCC Long-Term LEC Price Cap Plan*," (Dec. 1995) at 49-50.

This approach, which effectively assumes uniform input growth for interstate and intrastate services is conservative, *i.e.*, biases the TFP in a downward direction. Further refinements to directly allocate input costs to the interstate jurisdiction on the basis of separations factors or some other method would only serve to increase the interstate-only X-Factor measures set forth in Table 1 below.

Examining this issue from a purely economic perspective leads to a similar conclusion regarding the likely understatement of an interstate-only X-Factor calculated under the assumption of uniform interstate/intrastate input growth. The larger output growth combined with the more technologically advanced inputs of LEC interstate services will result in greater economies of scale in the provision of LEC interstate services and hence a greater magnitude for interstate-only TFP.

Table 1 below compares average X-Factors implied by the total company and interstate-only approaches. For purposes of this analysis, the interstate-only X-Factor is calculated using the uniform input growth method. Performing this calculation reveals that interstate services have inherent productivity levels persistently, systematically and substantially in excess of those calculated on a total company basis.

Table 1 Summary of Average X-Factors, FCC Methodology		
Years in Average	Total Company	Interstate-Only
1986-1995	5.2%	9.4%
1987-1995	5.9%	10.3%
1988-1995	6.0%	10.5%
1989-1995	6.1%	10.1%
1990-1995	5.8%	10.4%
1991-1995	5.2%	9.6%
Notes: Total Company figures per Chart D1, FCC Staff analysis, Appendix D, Access Charge Reform Order. Interstate-only figures derived from data and formulas used in Appendix D.		

In the Access Charge Reform Order, the Commission selected a base productivity factor of 6.0 percent, after concluding it reasonable to place more weight on the middle four averages for total company X-Factor (Excluding the Consumer Productivity Dividend (CPD)) (reproduced in Table 1) and to set the X-Factor near or at the upper end of the range of reasonableness (which the Commission determined to lie between 5.2 percent and 6.3 percent.)⁴⁸ Applying analogous reasoning to the interstate-only productivity factors in Table 1 suggests an interstate X-Factor as high as 10.5 percent. Even if the Commission were to determine that, given the higher range of values for the Interstate-only results, it would be appropriate to set the X-Factor near or at the

⁴⁸ See Access Charge Reform Order at paras. 138-140.

lower end of the range of reasonableness, this would lead to an X-Factor of at minimum 9.5 percent. It is clear from the data in Table 1 that applying any reasonable standard argues forcefully for an X-Factor in the range of at least 9 percent for interstate services of price cap LECs.

Due to complexities with the data series arising from new government index formulations, availability of reporting, and apparent errors in reported data, it has not been possible for Ad Hoc within the time frame of these comments to update completely the Commission's analysis to incorporate data from 1996 and 1997. However, Ad Hoc's preliminary analysis suggests that inclusion of data for 1996 and 1997 would not alter the basic result identified in Appendix 2 for the period 1986 to 1995 of an interstate X-Factor of at least 9 percent. The Commission appropriately found that "*averages, rather than yearly estimates, provide the most reliable basis in the current record for estimating incumbent productivity targets (including input price differential) for the immediate future.*"⁴⁹ Moreover, as described above, the Commission's methodology weighted the middle four averages (covering successively most recent five year periods) of X-Factor estimates shown in Table 1. Accordingly, updating the data series to reflect one or two years of additional data would not be expected to materially alter the average results given the strong LEC productivity growth trend during the period 1987 to 1991, and our preliminary analysis confirms this to be so.

⁴⁹ Access Charge Reform Order at para. 138.

The current X-Factor is set too low. The Commission's data and positions taken by ILECs before state regulatory authorities prove this point. The Commission has moved cautiously in increasing the X-Factor. The time has come for the Commission to take another step toward moving interstate access charges closer to the correct levels.

B. Pricing Flexibility

The Committee continues to support the availability of pricing flexibility to the extent that it is linked to clear evidence of competitive conditions in relevant markets.⁵⁰ ILECs should have pricing flexibility to respond to actual competition. Such pricing flexibility serves the public interest generally, because it holds the potential to send more accurate pricing signals to the market. Moreover, consumers could benefit from the lower prices and expanded choice that results from competition. In designing appropriate pricing flexibility, however, the Commission must ensure that ILECs cannot deter efficient competitive entry or unfairly burden the customers of less competitive service or geographic markets.⁵¹ Should the latter consequences flow from affording ILECs pricing flexibility, the public interest, on balance, will be decreased.

That being said, the Ad Hoc members have a significant concerns about the pricing flexibility proposals currently under consideration. At the outset, it is important to note that the proposals submitted by Bell Atlantic and Ameritech

⁵⁰ Ad Hoc Comments at 46-54.

⁵¹ Ad Hoc Comments at 48-54.

appear to be merely the slides which accompanied an oral presentation and do not contain a narrative analysis of the recommendations.⁵² Based on the summary nature of the information on the record and the relatively brief time period which it has to respond to the issues raised in the public notice, the Committee can, at this stage, only identify some of its questions and concerns regarding what appears to be the intent of the proposals.

1. Principles

In large part, Ad Hoc agrees with the principles expressed by Bell Atlantic. In a number of instances, the Committee would refocus or refine the point being made. As noted above, the Committee agrees that competitive market forces are superior to regulatory constraints in determining efficient levels of prices, investment and output and that prices should reflect market conditions and cost causation.⁵³ Ad Hoc also agrees that pricing flexibility should be adopted as an industry-wide standard, rather than through a piecemeal waiver process⁵⁴ and that different characteristics of the markets for various services require different

⁵² Letter from Kenneth Rust, Director, Federal Regulatory Affairs, Bell Atlantic, to Magalie Roman Salas, Secretary, Federal Communications Commission, April 27, 1998 ("Bell Atlantic Ex Parte"); Letter from Anthony M. Alessi, Director, Federal Relations, Ameritech, to Magalie Roman Salas, Secretary, Federal Communications Commission, June 5, 1998. An additional complication is that the slides are not numbered. For purposes of our discussion, we count the entire package, starting with the cover letter to Ms. Salas as page 1 and including the cover page of the slide presentation.

⁵³ As discussed above, the Committee does not believe that the market-based approach to access charge reform will drive prices to cost and for that reason, we urge the Commission to adopt a prescriptive approach.

⁵⁴ Bell Atlantic Ex Parte at 3.

criteria, time frames and pricing flexibility.⁵⁵ The Committee disagrees, however, that regulatory requirements should be removed “as markets are opened to competition.”⁵⁶ Rather, regulatory relief should be timed to occur when markets are, in fact, competitive. Similarly, where Bell Atlantic urges the Commission to “pursue a policy that rewards efficiency, not one that protects competitors,”⁵⁷ the Committee would instead urge the Commission to adopt a policy that encourages competition and economic efficiency, (these goals are not mutually exclusive), and protects end-users from the burdens of ILECs possibly cross-subsidizing competitive offerings with revenues from less competitive offerings.

2. RFP Pricing Flexibility

The Committee supports the availability of RFP pricing flexibility to allow ILECs to respond to RFPs with contract price offers in competitive situations.⁵⁸ The Committee would go one step further and suggest that the Commission develop a means for determining that once a certain number of RFP contract tariffs in an area have been approved, a sufficient level of competition has been established such that Commission pre-approval of subsequent RFP contract price offers is no longer necessary. This approach depends on the existence of actual competition. Moreover, the Commission should not allow ILECs to cross-subsidize RFP offerings onto prices below the relevant costs. The Committee

⁵⁵ Bell Atlantic Ex Parte at 12.

⁵⁶ Bell Atlantic Ex Parte at page 3.

⁵⁷ Bell Atlantic Ex Parte at page 3.

⁵⁸ Bell Atlantic Ex Parte at 19-20.

will provide a fuller analysis of the issue of competitive response tariffs in the comments it submits in response to the U S West Petition for Forbearance.⁵⁹

3. Reliance on Potential Competition

The issue which causes the most serious concern to the Committee is that the proposals for pricing flexibility submitted by Bell Atlantic and Ameritech appear to contemplate implementing pricing flexibility on the basis of potential competition for access services in specific geographic areas. For example, Bell Atlantic proposes that the Commission should allow Phase 1 pricing flexibility for transport where 100 DS1 equivalent collocated cross-connects have been installed statewide.⁶⁰ For purposes of Phase 2 pricing flexibility, the characterization of a wire center as competitive or non-competitive is based on whether a single competitor has collocated facilities, UNEs or its own facilities in the geographic area served by the wire center. Similarly, Bell Atlantic proposes that the Commission should allow Phase 1 pricing flexibility for switched access on the basis of the presence of state-approved interconnection agreements, the availability of interim number portability and 100 UNE loops in service.

The Committee strongly believes that pricing flexibility must be linked to clear evidence of competitive conditions in relevant markets.⁶¹ Rather than repeat arguments which have been explained in detail in the comment and reply

⁵⁹ See *Petition of U S West Communications, Inc. for Forbearance from Regulation as a Dominant Carrier in the Phoenix Arizona MSA*, CC Docket No. 98-157 (filed Aug. 24, 1998).

⁶⁰ Bell Atlantic Ex Parte at 21.

⁶¹ Ad Hoc Comments at 44-54, Ad Hoc Reply Comments at 14-18.

round of the Access Charge Reform proceeding, the Committee affirms the views it expressed in prior pleadings.

If the Commission does decide to base ILEC pricing flexibility on potential competition, serious questions must be answered about Bell Atlantic's proposals and whether the criteria proposed are sufficient to warrant various levels of pricing flexibility, discussed below.

Moreover, these criteria do not take into consideration other important indicators of whether a potential competitor can actually compete with the ILEC, such as the elasticity of supply and demand for the service or a close substitute, the market power of the competitor, time frame for connecting new customers and relative costs. The Commission has considered such factors in assessing whether to relax regulation of carriers that historically have held market power.⁶² Extending pricing flexibility to ILECs is a form of regulatory relief. The relevant ILEC proposals ignore these economically valid considerations. It is noteworthy that U S West recently has cited to these factors in a request for regulatory forbearance with respect to its high capacity offerings in the Phoenix, AZ Metropolitan Statistical Area, and thus has implicitly acknowledged the relevance of these factors to Commission decision to relax its regulation of ILEC pricing.

⁶² See e.g., *AT&T Non-Dominant Order*, *supra* n. 21; *In the Matter of COMSAT Corporation; Petition Pursuant to Section 10(c) of the Communications Act of 1934, as amended, for Forbearance from Dominant Carrier Regulation and for Reclassification as a Non-Dominant Carrier; Policies and Rules for Alternative Incentive Based Regulation of COMSAT Corporation; COMSAT Corporation; Petition for Partial Relief from the Current Regulatory Treatment of COMSAT World Systems' Video and Audio Services; Petition for Partial Relief from the Current Regulatory Treatment of COMSAT World Systems' Switched Voice, Private-Line, and Video and Audio Services*, Order and Notice of Proposed Rulemaking, File No. 60-SAT-ISP-97) (rel. Apr. 28, 1998).

The Commission could not lawfully adopt the Bell Atlantic or Ameritech proposals for pricing flexibility without providing a reasoned explanation as to why it has changed its view on the relevance of these economic factors.⁶³

4. Impact on Customers in Non-competitive Markets

From the perspective of end-users, it is troubling to note that Bell Atlantic's pricing flexibility proposal contemplates increasing prices to those customers who do not benefit from the presence of either effective or potential competition. In particular, Bell Atlantic proposes that Phase II pricing flexibility would allow ILECs to increase upper service band levels by as much as 10%, although rural high cost customers would be protected from unreasonable rate increases.⁶⁴ This wording unfortunately suggests that customers who are not in rural, high-cost areas would not be protected from unreasonable price increases. In any event, the Committee believes that existing price cap indices must continue to apply. Any rate increases to customers who do not have a competitive alternative which is the result of lower prices charged by the ILEC to meet competitive market conditions must be carefully scrutinized to ensure that captive customers (rather than the shareholders) are not unfairly bearing the burden of the ILEC's efforts at competition.

⁶³ See e.g., *Greater Boston Television Corp. v. FCC*, 444 F.2d 841, 852 (D.C. Cir.), cert. denied, 403 U.S. 923 (1971); *Greyhound Corp. v. ICC*, 551 F.2d 414, 416 (D.C. Cir. 1977); *Office of Communications of the Church of Christ v. FCC*, 560 F.2d 529 (2d. Cir. 1977).

⁶⁴ Bell Atlantic Ex Parte 18.

Similarly, it is not clear why Bell Atlantic proposes that the X-Factor should be reduced to reflect the impact of competition.⁶⁵ Because reductions in the X-Factor mean the ILECs can charge higher prices, this proposal suggests that the ILEC would, in the face of competition, charge higher prices than were necessary in the absence of competition. Given that one of the primary benefits of competition is to reduce prices to consumers, this proposal is at least counter-intuitive.

5. Conclusory Arguments & Unsupported Data

What makes responding to the Bell Atlantic's proposal as it currently is presented on the record very difficult are Bell Atlantic's use of conclusory arguments, unsupported factual data and shorthand references lacking explanation. For example, Bell Atlantic argues that the presence of local exchange competition can be demonstrated by the availability of number portability, CLEC telephone numbers in service, interconnection, UNEs, and the transport and termination of traffic. Yet as the Bell Operating Companies' experience with 271 applications demonstrates, the presence of local competition is not that easy to achieve. This is not to argue that the 271 criteria are controlling in this context, but rather to observe Bell Atlantic need to explain why these criteria are the only relevant factors to consider. In other examples, certain may be true for particular services or in some markets, but the implication

⁶⁵ Bell Atlantic Ex Parte at 3. As discussed above, the Committee believes the X-Factor should be increased to nine or ten percent.

is that the statements are true for all services in all markets. Such a broad brush approach is not appropriate given the great risk that improperly devised pricing flexibility could stunt the development of competition.

The following is a short list of statements, going page by page, which require further input or documentation in order to be meaningfully evaluated:

- State approved interconnection agreements have removed the remaining barriers to entry (page 4)
- The restructuring of access rates has changed the pricing flexibility required by ILECs (page 5)
- Data used to demonstrate Bell Atlantic's "uniquely competitive markets" (page 9)
- Substantial competition exists in the special access transport market (page 13)
- CLEC/CAP provided special access services are fully substitutable for ILEC provided services and can "stand-alone" (page 14)
- CLECs / CAPs are actively competing for switched transport services, particularly switched entrance facilities (page 15)
- Competition for switched Direct Trunked Transport is growing rapidly as CLECs / CAPs expand the use of collocation to interconnect their facilities with the ILEC's network (page 15)
- The factors which foster the growth of competition and competitive behavior in a market are rapidly growing in the switched access market (page 16)
- 25% market area sufficient to warrant Phase 2 pricing flexibility; 75% market area for Phase 3 (page 21,22, 28, 29)
- Transport, Phase 1 – 100 DS1 equivalent collocated cross-connects statewide;
- Switched Access, Phase 1 – negotiated interconnection agreements; availability of number portability; and 100 UNE loops in service
- Growth option with V&T, promotional offerings (page 23)
- Deaverage overflow ML Bus O/T (page 31)

The above discussion of issues and concerns is by no means exhaustive. The Committee looks forward to the opportunity to review a full explication of these proposals in the comments filed by Bell Atlantic and Ameritech and anticipates addressing these issues in detail in the reply round of this proceeding.

C. Make Whole or Make Money

As an alternative to the fully prescriptive backstop approach set forth in the Access Reform Order, the Ad Hoc Committee recommends that the Commission consider the "Make Whole or Make Money" framework which Ad Hoc described in its comments in this proceeding.⁶⁶ As the Ad Hoc Committee noted in its initial comments, the Commission cannot confer upon the ILECs the security of rate of return regulation (*i.e.*, guaranteed recovery of embedded costs) while concurrently granting them the pricing and earnings flexibility enjoyed by non-regulated firms. What the ILECs are seeking is a paradigm in which they enjoy all of the protections traditionally provided under RORR while retaining all of the benefits of a price cap system with no sharing or earnings cap.

The "Make Whole or Make Money" approach would allow ILECs to choose between a "make whole" option of guaranteed recovery of their embedded accounting costs, including the excess above economic cost levels, but under Commission oversight of their earnings and pricing; and a "make money" option, in which the ILEC would accept a prescription of access rates at

economic (TSLRIC) levels, but with pricing flexibility and no regulatory restraints on earnings. The Ad Hoc Committee's option-driven proposal would allow each ILEC to decide whether it or its ratepayers are to bear the risks and burdens and reap the rewards and benefits of the ILEC's investment decisions. Since an ILEC has the option of electing to be *made whole*, if it did not exercise that option, but instead chose to *make money* under the unregulated earnings option, but then failed to recover its costs and embedded investment, it could not later claim an unlawful taking. This approach would give the ILECs a direct path to pricing flexibility, avoid cross-subsidy concerns and possible claims of confiscation that might be raised by a mandatory prescription to economic cost, and may encourage ILECs to move to cost-based access rates far faster, and with more protection to access customers, than would be the case under the failed "market-based" approach.

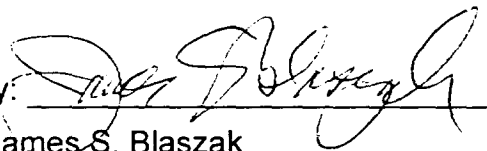
⁶⁶ Ad Hoc Comments at 3-4. See Appendix 3 for a description of this approach.

CONCLUSION

In view of the foregoing, the Ad Hoc Telecommunications Users Committee urges the Commission to reform access charges, increase the X-Factor, and address pricing flexibility as recommended herein.

Respectfully submitted,

AD HOC TELECOMMUNICATIONS
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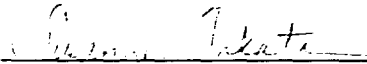
October 26, 1998

Certificate of Service

I, Suzanne Takata, hereby certify that true and correct copies of the preceding Comments of the Ad Hoc Telecommunications Users Committee in CC Docket Numbers 96-262, 94-1, 97-250 and Rulemaking 9210 were served this 26th day of October, 1998 via hand delivery to the following parties.

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October 26, 1998

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APPENDIX 1

Appendix 1: Summary of FCC Local Competition Survey Data, by ILEC

		CARRIER:	Ameritech	Bell Atlantic	Bell South	SBC	US West	GTE	Sprint	Totals
1	Local service lines sold directly to end users and billed by reporting carrier or affiliate	Residential	12,628,132	24,660,131	15,840,399	20,554,461	11,068,381	13,079,459	5,292,920	103,123,883
		Other	7,519,940	13,690,736	7,088,105	12,398,104	4,859,191	5,183,682	2,048,238	52,787,996
		Total	20,148,072	38,350,867	22,928,504	32,952,565	15,927,437	18,263,171	7,341,158	155,911,774
3	Local service lines sold to competing local carriers for resale, including Centrex lines	Residential	268,230	43,812	126,606	343,257	3,783	37,795	9,588	833,071
		Other	212,539	164,595	89,624	178,174	197,799	10,923	6,130	859,784
		Total	480,769	208,407	216,230	521,431	201,475	48,709	15,718	1,692,739
		Percentage of lines sold for resale to CLECs								
		Residential	2.1%	0.2%	0.8%	1.6%	0.0%	0.3%	0.2%	0.8%
		Other	2.7%	1.2%	1.2%	1.4%	3.9%	0.2%	0.3%	1.6%
		Total	2.3%	0.5%	0.9%	1.6%	1.2%	0.3%	0.2%	1.1%
4	Total local service lines (1)+(3)	Residential	12,896,362	24,703,943	15,967,005	20,897,718	11,072,164	13,117,254	5,302,508	103,956,954
		Other	7,732,479	13,855,331	7,177,729	12,576,278	5,056,990	5,194,605	2,054,368	53,647,780
		Total	20,628,841	38,559,274	23,144,734	33,473,996	16,129,154	18,311,859	7,356,876	157,604,734
7	Service lines sold to unaffiliated carrier as unbundled network elements (UNE loops) where reporting carrier does not provide bundled switching	Residential	-	-	-	-	-	-	-	-
		Other	-	-	-	-	-	-	-	-
		Total	68,573	34,652	8,448	13,940	340	7,018	-	132,971
		Percentage of lines sold as UNE loops								
		Residential	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
		Other	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
		Total	0.33%	0.09%	0.04%	0.04%	0.00%	0.04%	0.00%	0.08%
23	Interim portability: total numbers ported using call forwarding or other interim techniques	Residential	-	427	70	36	-	-	-	533
		Other	-	48,559	31,702	20,746	-	-	2,316	103,323
		Total	70,069	61,311	31,772	40,061	18,728	937	2,316	225,194
		Percentage of lines ported using interim techniques:								
		Residential	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
		Other	0.00%	0.35%	0.44%	0.16%	0.00%	0.00%	0.11%	0.19%
		Total	0.34%	0.16%	0.14%	0.12%	0.12%	0.01%	0.03%	0.14%

Notes: This table summarizes the responses to the FCC's First CCB Survey on the State of Local Competition, March 27, 1998, available for download from www.fcc.gov/ccb/local_competition/survey/responses. Data are for December 31, 1997. This summary also incorporates additional and revised responses submitted between March 28, 1998 and July 31, 1998. Line numbers above refer to lines in the Survey.

APPENDIX 2

Appendix 2

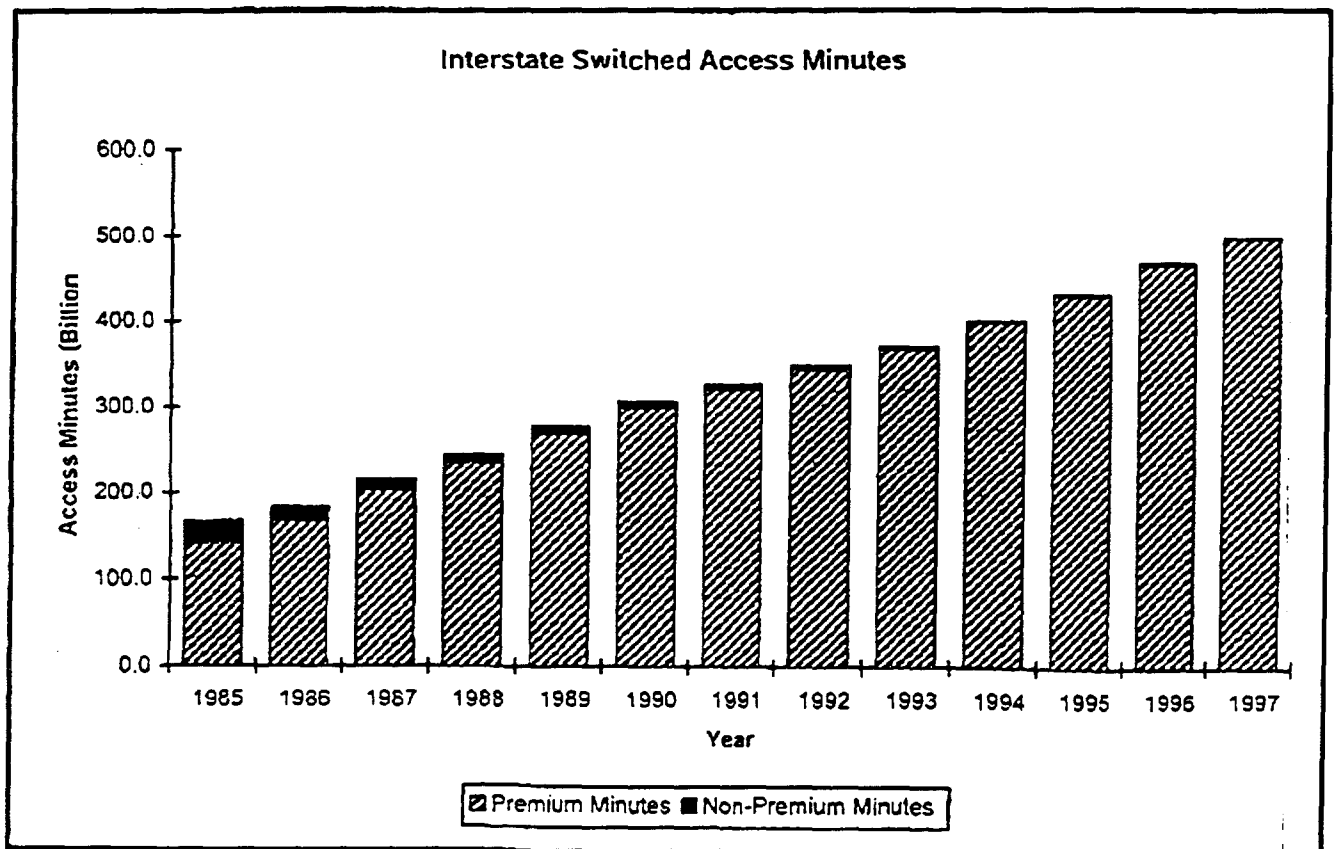
Table 11.3 Interstate Switched Access Minutes

Source: *Trends in Telephone Service*, Industry Analysis Division,
Common Carrier Bureau, Federal Communications Commission, July 1988.

TABLE 11.3

INTERSTATE SWITCHED ACCESS MINUTES
(FIGURES SHOWN IN BILLIONS)

	PREMIUM MINUTES	NON-PREMIUM MINUTES	TOTAL MINUTES
1985	142.4	24.7	167.1
1986	168.5	14.6	183.1
1987	203.9	11.9	215.7
1988	235.4	9.2	244.6
1989	269.1	8.0	277.1
1990	300.4	7.1	307.4
1991	322.2	5.8	328.0
1992	345.5	4.2	349.8
1993	368.3	3.0	371.2
1994	399.3	2.1	401.4
1995	430.3	1.6	431.9
1996	467.7	1.2	468.9
1997	498.4	0.7	499.1



APPENDIX 3

THE ILECs' CHOICE

"Make whole" or "make money" — the ILECs must choose!

Traditional rate of return regulation ("RORR") limits ILEC earnings but guarantees the recovery of prudent investments; the competitive model expands an ILEC's earnings opportunities, but requires that it bear the full risk of its investment decisions. What the ILECs are seeking is a paradigm in which they enjoy all of the *protections* traditionally provided under RORR while retaining all of the *benefits* of a price cap system with no sharing or earnings cap. The Commission should not confer upon the ILECs this kind of asymmetry, i.e., guaranteeing their recovery of embedded costs while concurrently granting them the pricing and earnings flexibility that is enjoyed by non-regulated firms. Instead, the ILECs must be required to choose either:

- a *Make Whole* approach, in which the risks *and rewards* of ILEC investment are shifted back to ratepayers, as they were under RORR; or
- a *Make Money* approach, in which the ILECs would be required to write off the "gap" as would any non-regulated company operating in a competitive market, in exchange for the opportunity to exploit their asset base and to retain without limit any earnings that can be generated therefrom.

Each of these options is consistent with the established legal precedent that "reward follows risk and benefits follow burdens." See, *Democratic Central Committee of the District of Columbia v. Washington Metropolitan Transit Commission*, 485 F.2d 786 (D.C. Cir. 1973), *cert. denied*, 415 U.S. 935 (1974).

Given the choice to retain the traditional regulatory "bargain," the ILECs cannot continue to raise spurious complaints about the specter of a "taking" in violation of Fifth Amendment protections against confiscation of private property.

The ILECs have challenged on confiscation grounds the Commission's authority to require them to set rates on any basis other than embedded costs. The force of this argument can be completely overcome if the Commission allows the ILECs to choose between a "make whole" approach or a "make money" approach. Although under the "make money" approach, the ILECs will be required to set rates below embedded costs, the election is voluntary, and the alternative, "make whole" approach (under which full investment recovery would be assured) is open and available to the ILECs. Under these circumstances, the ILECs cannot argue that the Commission has compelled them to set rates at levels that they believe to be

confiscatory.

The FCC has correctly recognized that the regulatory process has bestowed numerous and valuable benefits upon the ILECs — including Yellow Pages and ubiquitous cellular telephone licenses — collectively worth many multiples of the so-called "gap."

While the ILECs persist in speaking of "takings," they conveniently ignore the numerous and valuable "givings" that they have enjoyed under the current regulatory structure. These "givings" were expressly recognized in a recent speech by Chairman Reed Hundt on *Access Reform and Universal Service: Into the Thick of It*. Hundt identified many significant financial "givings" that regulators (and regulation) have bestowed upon the ILECs, including the Yellow Pages directory publishing business and cost-free licenses for cellular telephone service in every market — each of these a multi-billion dollar business. The extent of any "takings" claims must be considered in the context of these "givings" and the many other benefits of long-term incumbency.

The highly inflated claims of the ILECs regarding the level of "stranded investment" that would exist if access rates were set at forward-looking economic cost should not be accepted at face value.

ILEC claims of entitlement to recovery of so-called "stranded investment" are rooted in the theory that all of an ILEC's plant was acquired in support of its "obligation to serve" under franchise monopoly conditions. Even if one were to accept that entitlement theory, there would still be the *factual* question as to precisely *how much* of an ILEC's plant was acquired for this purpose. ILECs have not been required to obtain Section 214 preconstruction approval for more than a decade, and their capital purchases have been subject to minimal after-the-fact review since the onset of price caps. Many spending programs have been motivated by long-term strategic and competitive goals, and have been in pursuit of services and markets that, if regulated at all, are generally not regulated at the federal level. Under the mechanical operation of Parts 36 and 64, however, a significant portion of such outlays are summarily included within the interstate access services embedded revenue requirement. For this and other reasons, forward-looking economic costs associated with a specific service (e.g., switched access) frequently do not match the ILECs' embedded costs on an element-by-element basis — indeed, they can be higher *or lower*. Moreover, because it cannot be assumed that each and every asset on the ILECs' books was acquired for the provision of access or other core services, it

should not be assumed that these differences add up to the whopping "stranded investment" claimed by the ILECs. The ILECs' theoretical depreciation reserve calculations are highly influenced by their strategic business goals and are not a reliable measure of stranded investment. While the USTA has estimated a theoretical reserve deficiency of \$17.9-billion, AT&T's analysis shows a depreciation reserve *surplus*.

If an ILEC elects to be "made whole," the Commission should adopt a process modelled on the amortization approach adopted by the Commission for recovery of ILEC-owned inside wire, in Docket 79-105.

In the case of inside wire, ILECs were permitted to recover 12.5% of their embedded inside wire investment as of the end of 1983 in each of eight consecutive years. At the end of 1991, all inside wire investment had been written off, and ownership of those assets was transferred to the customer.

Under the "Make Whole" approach, the Commission would first need to determine the appropriate level of stranded investment for each ILEC, and the ILEC would have the opportunity to amortize 12.5% of that amount for each of eight consecutive years. During the period in which the amortization takes place, the electing ILEC would be subject to price cap regulation. The X-factor would be set by the Commission, based on the record in Docket CC 94-1, and the ILEC would be required to share and cap earnings in a manner consistent with the Commission's current price cap rule that applies when the ILEC elects the lowest (4.0%) X-factor option (50/50 sharing beginning at 100 basis points above the authorized rate of return, with an absolute earnings cap — 100% of excess earnings returned to ratepayers — at 200 basis points above the authorized ROR).

If an ILEC elects the "Make Money" alternative, then it must write-off its "stranded investment" and accept rate reinitialization, whereupon it can operate under price caps with no specific earnings limit.

The price cap LEC that elects the "Make Money" alternative should be required to first reinitialize its interstate rates at TSLRIC, and then be permitted to elect whichever X-factor and earnings option under the Commission's (then-existing) price cap rules best fits with its corporate objectives. Rate reinitialization and increases in the present range of X-factors should be adopted before the ILEC is permitted to exercise this choice.

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Rate Structure Principles

In evaluating rate structure changes, the Commission should consider alleged efficiency gains in the broad sense; carefully evaluate cost-justification; and, if warranted, establish a transition plan that avoids churn and accounts for rate shock.

Commission mandated changes should be made in the correct sequence to avoid undesirable consequences for the economy as a whole and to avoid rate churn. For example, ILECs have proposed to introduce call set-up charges based upon continued inefficient use of the current switched PSTN, rather than on the costs of the most efficient forward-looking technology. Adoption of such rate structure changes could disrupt significant parts of the economy that have for many years relied on the current rate structure. The disruption could be avoided if the carriers deployed networks that are customized for data applications and call set-up charges are based on the incremental costs of such networks. The incremental costs of such networks would be far lower than the embedded costs of the current network. If, however, call set-up charges are imposed based on the embedded accounting costs of today's, major businesses will be compelled to change the manner in which they operate. If charges are subsequently lowered dramatically because rates are aligned with forward-looking economic costs, the affected businesses will be driven to change their mode of operation yet again. Rate churn is the name for this very undesirable effect. To date, ILECs have not demonstrated economic efficiencies that outweigh the cost of rate churn.

Pending the development of effective competition in relevant access service markets, the Commission should protect customers through a prescriptive approach to setting access service rate structures and levels.

The Commission's Rules should ensure just and reasonable rates for customers of competitive and noncompetitive services. If pricing based on forward-looking incremental costs is appropriate for LEC services facing competition, it should also be required for non-competitive services. As long as all LEC services do not face competition and LEC costs are common to competitive and non-competitive services, the Commission must set the prices for all services based on TSLRIC or carefully regulate the allocation of LEC costs between competitive and non-competitive services. The TSLRIC of providing access service should not be materially different, if at all different, from the TELRIC of providing Unbundled Network Elements.